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# Reflections on Fund Management: Five Lessons from 25 Years

- ▶ **Don Phillips, Managing Director**

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Lesson One:  
Leadership is Not Permanent

## Biggest U.S. Fund Firms 1986

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1. Merrill Lynch

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2. Fidelity

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3. Federated

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4. Dreyfus

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5. Franklin

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6. Dean Witter

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7. Kemper

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8. Putnam

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9. Pru-Bache

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10. EF Hutton

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11. Shearson

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12. IDS

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# Biggest U.S. Fund Firms 2011

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1. Vanguard

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2. Fidelity

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3. American Funds

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4. BlackRock/iShares

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5. PIMCO

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6. JP Morgan

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7. Franklin Templeton

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8. Federated

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9. T. Rowe Price

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10. State Street Global Advisors

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11. Dreyfus

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12. Columbia

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# Long Gone

- ▶ Merrill Lynch
- ▶ Dean Witter
- ▶ Kemper
- ▶ Putnam
- ▶ Pru-Bache
- ▶ EF Hutton
- ▶ Shearson
- ▶ IDS

# New Entrants

- ▶ Vanguard
- ▶ American Funds
- ▶ BlackRock/iShares
- ▶ PIMCO
- ▶ JP Morgan
- ▶ T. Rowe Price
- ▶ State Street Global Advisors
- ▶ Columbia

## Reinvented or Surviving on Money Market Assets

- ▶ Fidelity
- ▶ Franklin Templeton
- ▶ Federated
- ▶ Dreyfus

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Lesson Two:  
Predictions Often Miss the Mark



## 1986 Predictions

- ▶ Banks will join brokerages and dominate industry because they control distribution
- ▶ No-load funds will win from disintermediation theme
- ▶ Passive funds will trump active, as academic evidence supports indexing

## 2011 Reality

- ▶ Both banks and brokerages blew it. Owning distribution didn't lead to success
- ▶ No-load shops like Vanguard and T. Rowe Price did win, but so did load shops like Franklin, American Funds, and JP Morgan. Many like Fidelity simply offered both load and no-load funds
- ▶ Passive shops like Vanguard, I-Shares, and State Street Global Advisors did win, but so did active shops like Fidelity, PIMCO, American Funds

## Predictions Generally Misguided

- ▶ The way the debate was framed was often wrong or beside the point
- ▶ Smartest people in the industry focused on many of the wrong things
- ▶ Lots of wasted effort and ink
- ▶ We should remember past debates and be humble in future predictions

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# Lesson Three: Change is Not Random

# Shared Traits of Winners and Losers

## Losers

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Closed architecture

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Higher cost

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Hot concepts

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Short-term sales focus

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“Funds are sold”

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## Winners

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Open architecture

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Lower cost

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Investment merit

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Long-term investor focus

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“Funds are bought”

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# Salesmanship vs. Stewardship

## Salesmanship

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Merrill Lynch

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Dean Witter

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Pru-Bache

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EF Hutton

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Shearson

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## Stewardship

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Vanguard

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American Funds

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JP Morgan

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T. Rowe Price

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PIMCO

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Lesson Four:  
Investor Experience is Paramount

# Asset Managers Often Focus on the Wrong Things

## What We Focus on

- ▶ Near-term investment performance
- ▶ Fund category ranking
- ▶ Finding hot fund, asset class

## What Matters

- ▶ Long-term investor experience
- ▶ Retaining clients
- ▶ Curbing investor instincts
- ▶ Clients achieving goals



# The Real Test is Whether Investors Succeed

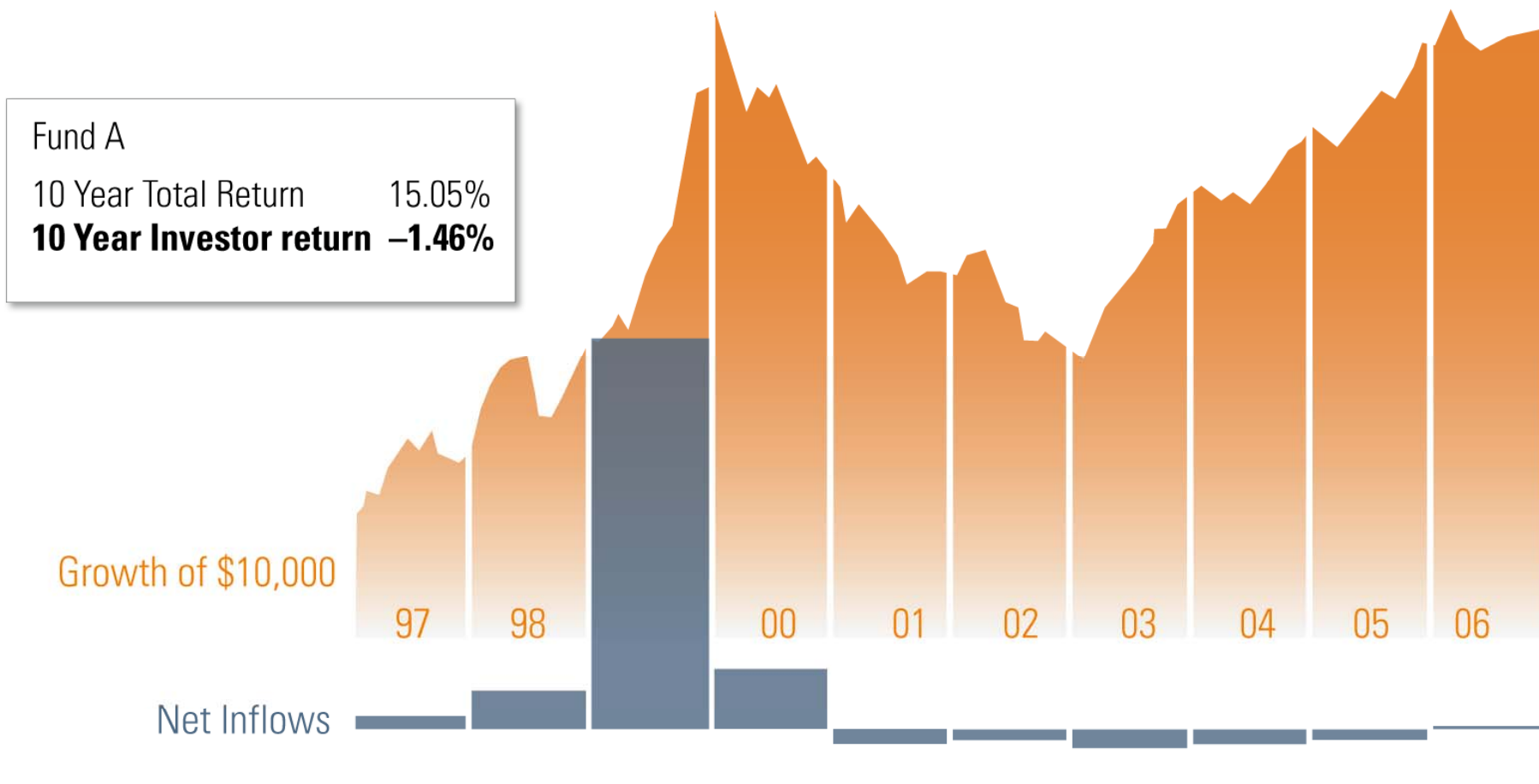
## Total Return

- ▶ Time-weighted calculation
- ▶ Assumes investor buys and holds for entire period with no additional investments

## Investor Return

- ▶ Money-weighted calculation
- ▶ Accounts for aggregate monthly purchases and sales by all of a fund's investors

# Investors Often Miss Benefits of Fund Ownership



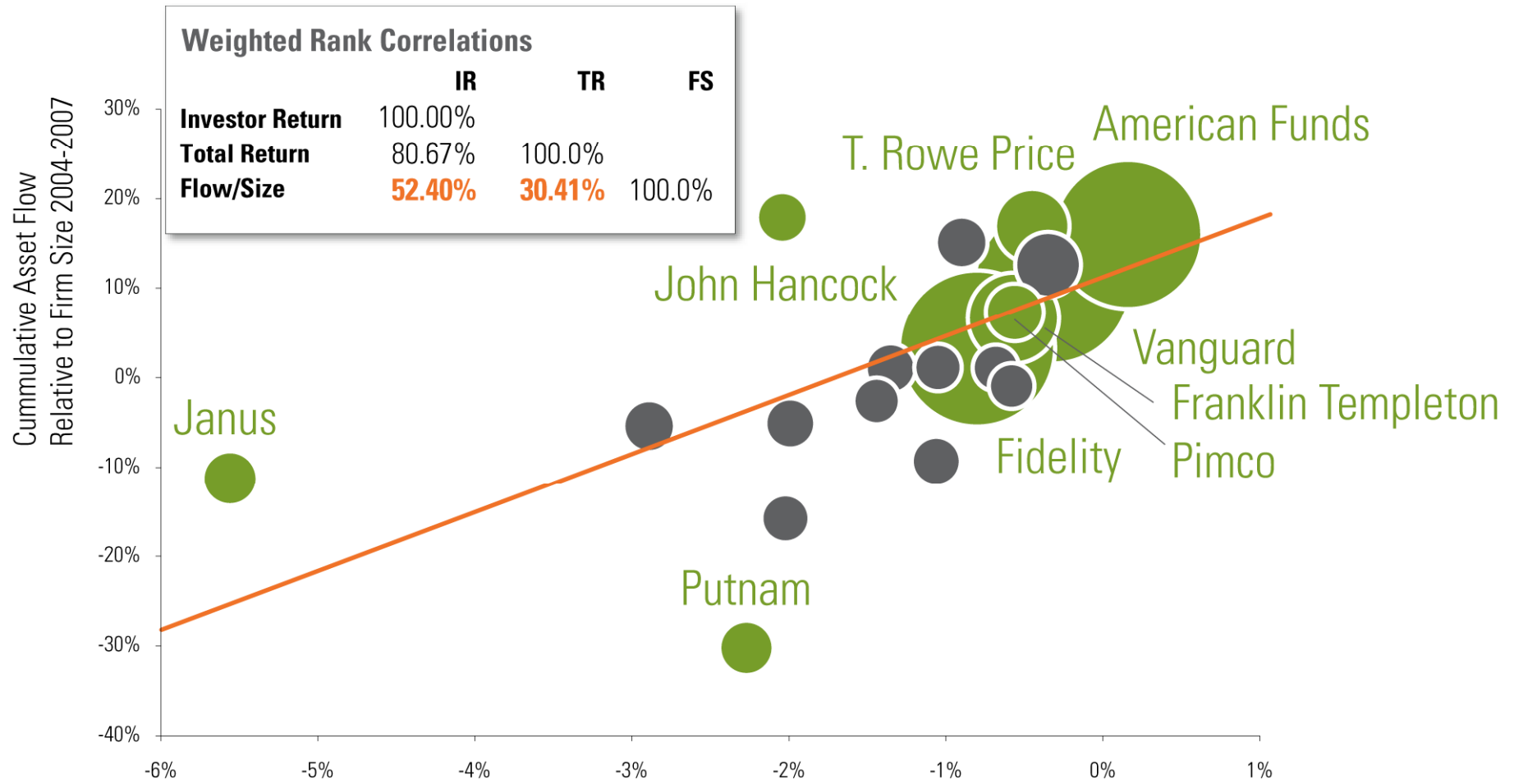
Annual Return (%)	12.7	34.9	120.1	-17.1	-27.8	-17.7	43.8	20.9	24.4	8.8
Net Assets (\$mil)	5.3	9.9	72.4	118.9	69.1	45.6	52.2	51.9	57.1	63.2

## Behavior Gap Exists Among All Types of Funds

Fund Group by Asset Class	Investor Return	Total Return	IR-TR Gap
U.S. Diversified Funds	2.32	3.30	-0.98
U.S. Sector Funds	3.89	6.08	-2.19
Balanced Funds	3.96	5.13	-1.17
Intl. Diversified Funds	4.92	5.98	-1.06
Intl. Regional Funds	6.37	8.77	-2.40
Taxable Bond Funds	4.46	6.27	-1.81
Municipal Bond Funds	2.04	4.02	-1.98
Alternative	9.94	13.07	-3.13
All Funds	3.38	4.71	-1.33

Asset weighted returns, 10 years ending 12/31/2010

# It Pays to Mind the Gap



Investor Return—Total Return Gap  
10 YR Returns thru Dec. 31, 2007

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Lesson Five:

We are All in the Behavior Modification Business

## Fund Promotion Needs to Change

- ▶ January 2000 peak: Tech funds dominate fund ads
- ▶ January 2003 trough: Government bond funds widely advertised
- ▶ Summer 2007 peak: Leveraged ETFs prominent among fund ads
- ▶ February 2009 trough: Absolute return funds highly advertised
- ▶ The industry has long history of encouraging risk taking at peaks and caution at troughs

## Manager Interests Should Be Aligned with Shareholders'

Ownership Level	% Rank Cat 5yrs	# of Funds
More than \$1,000,000	39	391
Between \$500,001 and \$999,999	42	194
Between \$100,001 AND \$500,000	45	656
Between \$50,001 AND \$100,000	48	273
Between \$10,001 AND \$50,000	52	367
Between \$1 AND \$10,000	53	144
\$0	53	1,860

Ownership data is based on the most recent SAI as of 2/28/2010

# Manager Investment Correlates with Stars

Star Rating	Tenure (Years)	Manager Investment
5	6.2	\$300,061
4	6.3	\$250,890
3	5.4	\$161,602
2	4.6	\$124,810
1	3.8	\$110,991

Morningstar Principia, 01/31/10



## Amplify or Moderate?

- ▶ Fundamental moral choice: Do you amplify or moderate fear/greed cycle?
- ▶ In the long run, amplifiers lose
- ▶ In the short run, amplifiers can make lots of money and inspire copy cats
- ▶ Advisors must ask with whom are they are willing to do business?
- ▶ In time, if the investor doesn't win, we all lose

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